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U.S.-China Tariffs: What's Next?

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Key takeaways

» *On Friday, July 6, 2018 the U.S. Trade Representative's Office (USTR) is expected to move forward with implementing a 25% tax on $34 billion worth of Chinese imports.*

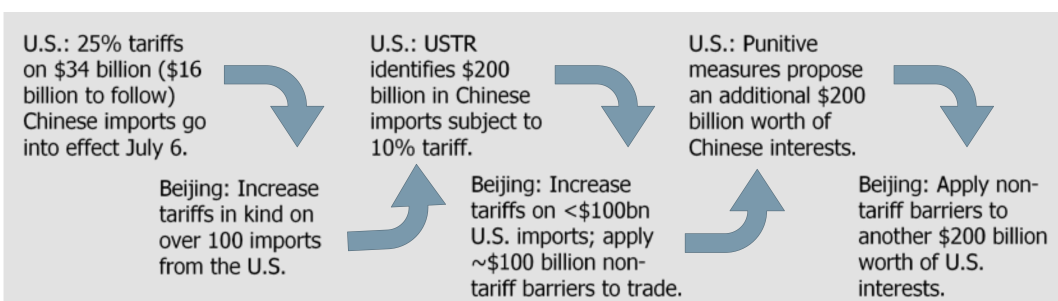
» *We believe that the risks related to a trade war involving the U.S. and China have notably increased over the past couple of weeks. While we expect cooler heads to prevail, a prolonged trade spat could affect our current market views and targets.*

What it may mean for investors

» *We still believe that the factors underpinning our midyear outlook for 2018 are likely to persist in the near term. That said, we highlight potential directional changes to our investment guidance should trade-related discussions escalate.*

On Friday, July 6, 2018 the USTR is expected to move forward with implementing a 25% tax on $34 billion worth of Chinese imports.[1] While the USTR's impending move has been expected, the Trump administration's declaration on June 15 to increase tariffs on nearly all Chinese imports has elevated the specter of a trade war. While the prospect of a trade war between the U.S. and China has increased, we nevertheless believe that the risks remain contained—for now.

Chart 1. Recent escalation in trade war dispute



Source: Wells Fargo Investment Institute, July 1, 2018.

[1] In March 2018, the USTR identified damages in the amount of $50 billion related to its Section 301 investigation. Following its product list and dialog with the private sector, a pool of goods worth only $34 billion was identified for which a 25% tariff would be applied. An additional $16 billion in goods is expected to be announced after July 6.

Is a trade war inevitable?

Our base case scenario heading into the second half of 2018 is that trade-related concerns are a risk to our economic and market views, yet we expect these risks to remain contained so long as tariffs imposed by the U.S. are used as precisely targeted instruments of negotiation and not blunt tools of protectionism.[2] Therefore, a trade war is not inevitable, in our view, so long as productive negotiations between the U.S. and China continue to move forward. This view has not changed.

So what's changed?

President Donald Trump's proposal on June 15 to raise tariffs on a pool of $200 billion worth of imports (expanding to potentially another $200 billion) has changed our risk calculus. While the president has asked the USTR to identify a list of imports worth $200 billion likely subject to additional tariffs of 10%, we believe that the remaining punitive measures on China could come through an enhanced government crackdown on foreign investment in the U.S. via expanded CFIUS[3] authority. Such a move would reduce constraints on the president's ability to impose restrictive measures on China as the U.S. looks to increase pressure in negotiations.

Assessing the risks on the Chinese side of the equation has been pretty straightforward up until now, as policymakers in Beijing have signaled their desire to avoid a trade war, yet are willing to respond to tariffs and restrictive policies in a one-for-one, like kind manner. From this perspective, China is constrained by actions taken by the U.S. That said, China only imports $130 billion from the U.S. and cannot respond dollar for dollar if the U.S. imposes $200 billion on Chinese imports to the U.S. As a result, other more ambiguous measures imposed by Beijing (such as increasing non-tariff trade barriers) open the door to uncertainty and potential for policy missteps on both sides. The potential for non-tariff measures introduces uncertainty and, in our view, leaves potential for negative economic consequences on both sides.

Table 1. How could this situation play out?

Scenario	Probability	Economic and market implications
Quick resolution	10%	Most favorable outcome
Rapid escalation	10%	Most unfavorable outcome
Prolonged negotiation	80%	Favorable outcome

Source: Wells Fargo Investment Institute, July 2, 2018.

[2] *"Framing the Economic Implications of a Trade War,"* Wells Fargo Investment Institute International Strategy, March 22, 2018.

[3] Committee on Foreign Investment in the United States (CFIUS) is an inter-agency committee that reviews foreign acquisition of firms and assets of national security interest.

How could this situation play out?

We see three likely ways that the current trade disagreement between the U.S. and China could develop over the coming weeks and months. It is important to note that two of our three scenarios (a combined 90% probability in our estimation), offer what we believe would be a positive outcome that would support a continuation of the global recovery:

1. **China quickly acquiesces on a resolution to U.S. intellectual property and trade deficit concerns. Most favorable outcome *(10% likelihood).***

While a low probability, we believe that policymakers in Beijing could favor a quick resolution to the current trade disagreement as business sentiment wanes and economic activity in China eases. Watch for commentary out of Beijing that would suggest a more conciliatory tone toward the U.S. on trade, with language specifically emphasizing historically strong trade relations between the two countries and a renewed desire to restart negotiations that had been put on hold.

This scenario could lead to a rapid market recovery and be generally positive for our expectation of an expanding global recovery. We would expect a quick recovery in equity prices, supporting our favorable outlook for the second half of the year. Under this scenario for equities, we continue to favor pro-cyclical sectors, which tend to benefit the most from economic growth. These would include the Financials, Industrials, and Consumer Discretionary sectors. The recent sharp sell-off in emerging market (EM) equities could likely see a reversal and generate a meaningful short-term return. We believe the Federal Reserve (Fed) would stay on a gradual rate increase path with longer-term rates moving back to the highest levels of the year. We believe short-term bonds would provide investors better returns than longer-term maturities, while we would expect credit spreads to remain at relatively tight levels over the near term.

2. **Policy response escalates between the U.S. and China, closing the door to negotiations. Most unfavorable outcome *(10% likelihood).***

Under this scenario, a trade war between the U.S. and China would be difficult to avoid as the conditions related to additional tariffs by the U.S. outlined earlier in this report play out. Here, Beijing would likely remain committed to saving face in light of heightened pressure from the U.S., as tariffs on imports ratchet higher and Beijing responds in kind with its own tariff and non-tariff measures. We believe that this scenario has a low likelihood of playing out, given the potential economic consequences to both countries. That said, the likelihood of this scenario could increase if trade negotiations fail to restart in the coming weeks, if U.S. policymakers double down on higher tariffs, and if Chinese officials increase regulatory and other means to limit commerce with U.S. firms.

Many U.S. firms rely on China for raw and semi-finished inputs. If a trade war were to escalate over a 2-3 month period, we would expect to see business investment activity pause, which would act as a drag on broader economic activity. Prices would likely rise in the near term as tariffs increase the cost of imports, and some firms would be forced to pass rising costs along to consumers or shutter. Labor market conditions in the U.S. could also weaken as firms postpone hiring decisions. We believe the likelihood of a U.S. recession in 2019 would increase.

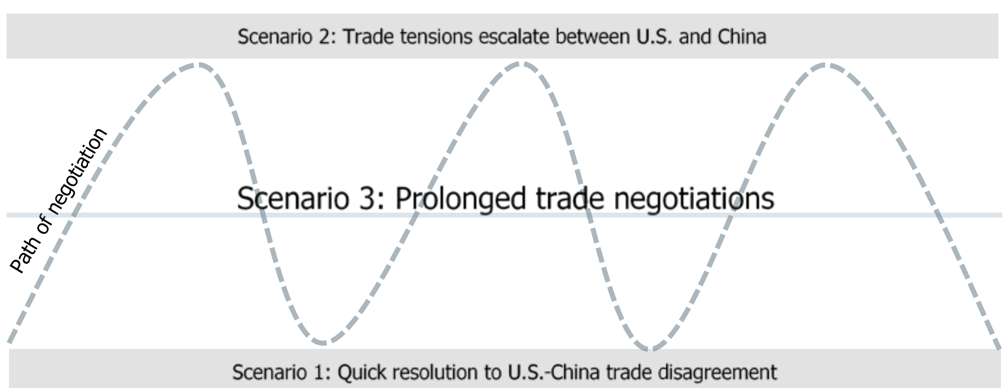
Trade-related concerns could be a major headwind to equity market momentum, but we generally expect domestic small-cap equities would outperform large caps. As a result, our targets for all or nearly all of the equity asset classes would need to be adjusted lower. Our current sector weightings would likely shift from favoring cyclicals to favoring defensives. Falling bond yields and a more-dovish Fed would likely not be good for the Financials sector. Slower consumer spending and business investment would likely be negative for the Consumer Discretionary and Industrials sectors. We believe an escalating policy response would lead to additional flattening of the yield curve through lower long-term rates, and there is risk that the yield curve would invert. Under such a scenario, we believe it is likely that the Fed would cease or slow their pace of rate increases.

3. **News headlines swing between worrisome and reassuring, as negotiations drag on, but a deal is eventually struck. Favorable outcome *(80% likelihood).***

The two countries have long-term differences regarding sharing technology, but compromises to narrow the U.S. trade deficit with China could form the basis for a workable deal for the next year or two. We believe that the likelihood of the third scenario playing out is greater than the first two, and that an eventual deal is overwhelmingly the most likely outcome. Yet, China's desire to maintain a strong presence in the face of heightened pressure from the U.S. on trade issues could prevent a quick resolution given the current circumstances.

Escalating punitive policy responses would produce unfavorable economic circumstances for both countries, particularly as China's economy slows this year as Beijing implements economically sensitive policy reforms. In this tightrope walk between saving face and preventing damage to economic activity from both the U.S. and Chinese positions, we believe that policy negotiations (while facing increasing headline risks) will continue down a long and winding path.

Chart 2. How could trade tensions between the U.S. and China play out?



Source: Wells Fargo Investment Institute, July 1, 2018.

The prolonged negotiation would likely increase market volatility and keep investors on edge during periods of heightened rhetoric. We would look to take advantage of these temporary market dislocations to tactically position portfolios. Rebalancing portfolios during these times of volatility can be an effective strategy that we believe investors should embrace. Increased volatility and dispersion is an environment in which alternative investments can potentially provide heightened benefits for investors.

What does all of this mean for our current market views?

Our midyear outlook for 2018 calls for continued positive economic growth in the U.S. and international economies, moderately higher inflation and a positively biased view on global risk assets. These views have factored in the growing-yet-limited risks surrounding a trade war this year, and we do expect financial markets to face periods of heightened market volatility as trade tensions ebb and flow. This view is subject to change, however, if risks related to scenario two (outlined above) contribute to higher levels of volatility. However, we still believe that the factors underpinning our midyear outlook for 2018 are likely to persist in the near term.[4]

[4] See our Midyear Outlook 2018 for the latest market targets and forecasts.

Risks Considerations

Each asset class has its own risk and return characteristics. The level of risk associated with a particular investment or asset class generally correlates with the level of return the investment or asset class might achieve. **Stock markets**, especially foreign markets, are volatile. Stock values may fluctuate in response to general economic and market conditions, the prospects of individual companies, and industry sectors. **Foreign investing** has additional risks including those associated with currency fluctuation, political and economic instability, and different accounting standards. These risks are heightened in emerging markets. **Small-cap stocks** are generally more volatile, subject to greater risks and are less liquid than large company stocks. **Bonds** are subject to market, interest rate, price, credit/default, liquidity, inflation and other risks. Prices tend to be inversely affected by changes in interest rates.

Alternative investments carry specific investor qualifications which can include high income and net-worth requirements as well as relatively high investment minimums. They are complex investment vehicles which generally have high costs and substantial risks. The high expenses often associated with these investments must be offset by trading profits and other income. They tend to be more volatile than other types of investments and present an increased risk of investment loss. There may also be a lack of transparency as to the underlying assets. Other risks may apply as well, depending on the specific investment product.

Sector investing can be more volatile than investments that are broadly diversified over numerous sectors of the economy and will increase a portfolio's vulnerability to any single economic, political, or regulatory development affecting the sector. This can result in greater price volatility. Risks associated with the **Consumer Discretionary** sector include, among others, apparel price deflation due to low-cost entries, high inventory levels and pressure from e-commerce players; reduction in traditional advertising dollars, increasing household debt levels that could limit consumer appetite for discretionary purchases, declining consumer acceptance of new product introductions, and geopolitical uncertainty that could affect consumer sentiment. Investing in the **Financial** services companies will subject an investment to adverse economic or regulatory occurrences affecting the sector. There is increased risk investing in the **Industrials** sector. The industries within the sector can be significantly affected by general market and economic conditions, competition, technological innovation, legislation and government regulations, among other things, all of which can significantly affect a portfolio's performance.

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